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Statement by

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Introductory comments

I am pleased to be here today to discuss the environment for small business financing and the role of banks in providing credit to small firms.

Small businesses are a vital part of our economy. They play a key role in the generation of jobs, new ideas, and the preservation of the entrepreneurial spirit; no one would question the contribution that a thriving small business sector makes to the well-being of our nation. It is therefore appropriate that small businesses hold a special place in the considerations of policy makers at all levels of government.

The Federal Reserve Board has devoted considerable effort to building our knowledge of the characteristics of small businesses and their use of financial services. As the Committee is aware, we have recently completed our second National Survey of Small Business Finances; Board staff are now processing the results of extensive interviews with more than 5,000 small business owners around the country. Some of the early findings from the survey were published in the July 1995 Federal Reserve Bulletin, and we will continue to analyze and report on the data as they become available. I will refer to this and other survey information in my remarks this morning.

Credit Availability Today

As I developed my thoughts for this hearing, I came to appreciate how much more pleasant it is to report on conditions in good times than in bad times. When Chairman Greenspan appeared before this committee in early 1993, a tepid recovery from recession was beginning to give way to more solid expansion. But commercial banks were still struggling with severe loan problems that resulted from excessive optimism in real estate and certain other loan markets in the 1980s. Because of large loan losses, many depository institutions had failed or been merged. Although there were signs in 1993 that banks were on the mend, credit conditions generally remained quite tight. The sting of the "the credit crunch" was still a fresh memory in the minds of borrowers and lenders, not to mention policy makers.

Out of concern that exaggerated lending restraint might have been fostered by regulatory and legislative reactions to the numerous problems in the industry, the regulatory agencies undertook an extensive review of their policies and practices. This review produced a number of measures aimed at removing impediments that might stand in the way of lending to creditworthy borrowers. Former Federal Reserve Governor John LaWare, in testimony two years ago, highlighted for this Committee many of these changes.

Since then, the agencies have continued their efforts to reduce the burden of regulation and to ensure that examiners evaluate bank lending in a consistent, prudent and balanced manner.

I think we would all agree that the financial environment today is markedly improved from that of 1993. While undoubtedly there remain pockets of weakness and problems for individual small businesses, a wide array of statistical indicators suggest that access to bank credit has eased appreciably for all businesses. Business loans at banks have expanded rapidly since 1993. Indeed, the volume of commercial and industrial loans at banks grew strongly in 1994 and then last year registered its largest percentage increase in more than a decade (13 percent).

Small businesses have participated in this expansion. Data collected from banks in their June Call Reports reveal that small commercial loans (defined as loans of $1 million or less and including those secured by commercial real estate) increased more than 7 percent between June 1994 and June 1995. Roughly one-third of the growth in small loans over that period occurred at 7,000 mostly small and regional banks whose business loan portfolios comprise only small loans.

A good portion of the expansion, however, was at large banks (those with assets of $5 billion or more). Part of the growth at large banks reflected the effect of bank mergers that moved more banking assets into the largest size categories. Nonetheless, even after adjusting for these transactions, large institutions expanded their lending to small firms an estimated 4 percent. We sometimes forget that large banks account for an important share of loans to small businesses, even though such loans may only be a small fraction of a large institution's total assets.

The pickup in business loan growth has been, in important part, a demand-related phenomenon. As the economy has grown, business needs for financing have expanded as well.

But the willingness of banks to supply credit also has been on the upswing. Continued improvements in bank profits, healthy capital positions, and low delinquency rates on business loans have encouraged banks to compete aggressively for business customers. The Federal Reserve conducts quarterly surveys of senior loan officers at sixty large banks around the country. For ten consecutive quarters since mid-1993 until the end of last year, these banks, on net, reported easing the terms and standards applied to business loans for all sizes of borrowers. Respondent banks last year attributed their easing primarily to increased competition from other banks and, to a lesser extent, from nonbank lenders. This easing has shown up in surveys of lending terms: for example, the spread between rates on business loans and market interest rates fell last year for loans of all sizes.

Perhaps the most telling evidence of improved financing opportunities are reports from small businesses themselves. Small and mid-sized firms surveyed by the National Federation of Independent Businesses (NFIB) had reported that "interest rates and financing" were among their most pressing problems in the early 1990s. However, only a small percentage of firms cited this as a concern in recent surveys. In addition, the net percentage of NFIB respondents reporting that credit was more difficult to obtain dropped appreciably from peaks in 1990 and 1991 and has fluctuated around low levels over the past year. The NFIB surveys have been consistent with reports heard at the Federal Reserve. For example, the Federal Reserve District Banks meet periodically with representatives from the small business and agricultural sectors; representatives at these meetings generally have been quite positive with regard to credit availability.

It would appear from our latest quarterly surveys of banks that the trend toward easing standards for business loans has come to an end, but there is no sign of reversal, and banks, on balance, remain accommodative to business credit demands. Given prospects for moderate growth in economic activity and the healthy position of banks, the outlook for bank lending to small businesses continues to be favorable.

While we are pleased with the improvements in credit availability, it would be foolish to assume that no problem areas exist or that small businesses are no longer vulnerable to changes in the financial environment. The small business community is diverse. Many are quite small without the operating history or assets that make them good credit risks. Start-up businesses may have high growth potential but little equity. Because most small businesses have no access to public debt markets and equity markets, they are likely to be especially sensitive to developments that affect institutional lenders and local credit markets.

As we consider the potential problems that small businesses may face down the road, we would like to know more about their sources of credit. Our survey of small businesses provides some useful insights in this regard.

Sources of Small Business Credit: Survey Evidence

In our 1993 survey, 84 percent of small and medium-sized businesses identified a commercial bank as their primary financial institution. Banks were used more often than any other type of supplier. Most small firms used checking services at banks, and commercial banks are used twice as often as any other source for lines of credit, loans or leases.

Most small businesses used a commercial bank located close to the firm--indeed, about 85 percent of all suppliers of financial services to small businesses were located within 30 miles and about half of the depository institutions were within two miles.

About one-third of small firms also used nondepository institutions for financial services, and twenty percent had some loan from a nondepository source. The most common loans from these sources are vehicle loans and capital leases. Such loans are generally secured by tangible assets and often supplied by the captive finance companies of manufacturers of automobiles and other equipment. In contrast, small businesses rarely obtain unsecured loans or lines of credit from nondepository institutions. Slightly fewer than ten percent had loans from family and friends.

The survey indicates that the use of nonbank sources increases with firm size. In particular, very small firms rarely used nondepository sources, whereas about forty percent of firms with fifty or more employees used nondepository sources.

Overall, the survey confirms that banks, especially local institutions, continue to play a major role in small business finance. The relationship between banks and small businesses involves a wide range of services supplied by the bank.

Looking Ahead: Banks and Small Business Lending

Looking ahead, there are a number of developments in banking markets that may be significant for small business borrowers. Perhaps the most prominent is the ongoing consolidation of the banking industry. Some fear that this trend may impede the flow of credit to small businesses and disrupt the relationships that many small businesses have with their local banks. This issue deserves careful attention, and I think it worthwhile to offer a few thoughts on the subject this morning.

First, it is important that we put the trend in merger activity in perspective. In the past ten years, the U.S. banking structure has undergone extensive change as banks have adjusted to the removal of longstanding restrictions on interstate banking and have responded to technological change and growing international competition. One result has been a sharp decline in the number of banking institutions--from more than 14,000 in 1985 to near 10,000 in 1995. Part of this decline was a result of bank failures: nearly 1,200 banks were forced to close and many weak institutions were merged.

Despite the decline in the number of banks, the number of banking offices and branches has risen sharply. (Banking offices jumped from 53,000 in 1980 to 65,000 in 1995.) There appears to have been no reduction in the availability of banking offices serving the public.

Moreover, analyses of banking markets over the years have provided little support for the notion that when large banks enter a market, they drive out the smaller banks. Rather, small banks have been and continue to be able to retain market shares and operate profitably in competition with larger banks. Our staff studies have shown that smaller banks typically perform as well or better than their larger counterpart, even in markets dominated by large institutions.

This makes it hard to accept the notion that profitable lending opportunities in our local communities will be unmet. If the local bank is making profitable small business loans, it seems logical that its acquirer would continue to make those loans. Should large banks find it is too costly to establish a lending presence in small business markets--perhaps because it is inefficient for large, remote institutions to maintain close working relationships with small customers--then other small banks in the area will be positioned to fill the gap. Consistent with this view, there were reports that community banks were eagerly looking to increase their market shares following some of the larger bank mergers last year.

Although some banking relationships inevitably will be disturbed when ownership and management change, we would expect these effects to be short-lived.

I offer these generalizations with caution. The Federal Reserve takes very seriously its responsibility for evaluating the possible impact of bank mergers on local markets. We have found that each assessment must be done on a case-by-case and market-by-market basis. To this end, we devote considerable resources to assessing competitive impacts, CRA concerns, and a variety of other factors. We will be watching closely for evidence that small businesses are being disadvantaged by bank mergers.

Other Developments

A number of other changes in the credit markets seemingly bode well for small business financing, including the efforts of large institutions to meet community development concerns and enhance their presence in local markets. Recently, large West Coast banks have announced programs that would channel billions of dollars into small business lending. Some of these programs reportedly have been structured to streamline the application process and make it easier for small businesses to obtain loan approval on a timely basis.

In addition, new technologies and information flows are providing opportunities for banks and other lenders to more efficiently evaluate loan risks. One technique that is rapidly gaining acceptance is credit scoring. Credit scoring is a statistical procedure that provides an estimate of default probability for individual loans, based on borrower and loan characteristics. The development of credit scoring models requires that lenders have access to a large amount of historical information on the performance of loans with similar characteristics. It inevitably will take time to develop data bases of small business loans, given the diverse characteristics of the millions of small borrowers. But, once developed, credit scoring and loan standardization may offer significant cost advantages for evaluating the risks associated with lending. Many large banks already have begun to probe the possibilities of credit scoring techniques for small business markets.

As credit scoring and loan standardization become more commonplace, we may well see growth in the amount of small business loan securitization. To date that growth has been hampered by the huge diversity among small business borrowers and the difficulty in accurately assessing the riskiness of pools of nonstandard small business loans. In contrast, the bulk of loans that are backed by the Small Business Administration (SBA) have been more easily securitized because they are known to be low risk by virtue of their guarantee. The ability to securitize non-SBA loans would increase the liquidity of small business lending and provide banks and other lenders with additional sources of funding. We anticipate that the cost savings generated through these new processes will be passed on, at least in part, to small business customers.

Clearly not all small business loans are going to be appropriate candidates for securitization, and not all banks will wish to adopt complex statistical models for managing risks. There will continue to be a market for nonstandard small business lending and a role for regional and community banks. Of course, we should also expect that small businesses that do not easily fit the standard models will not share in the cost savings that credit scoring will provide.

The agencies also have worked to improve the liquidity of small business loans by refining the risk-based capital standards for those loans sold with recourse. In response to section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994, the agencies lowered the capital requirement for small business loans that are transferred with recourse by well capitalized banking organizations. This change should facilitate the securitization of small business loans, while at the same time ensuring that qualifying banks hold adequate capital.

The banking agencies are mindful of the fact that loans to small businesses are vulnerable to regulatory burden as well. Spreading fixed regulatory compliance costs over small balances can make such loans more costly to originate than large loans. Thus, the agencies took great care to avoid unnecessary costs when we implemented safety and soundness standards pursuant to section 132 of FDICIA. That law directed the agencies to provide safety and soundness standards for, among other things, loan documentation and credit underwriting. Rather than prescribing detailed and costly requirements on what should be contained in a file for a small business loan, the standards establish goals for the documentation, leaving the specific methods for achieving those goals to each institution.

Summary

Let me conclude by saying that I am optimistic about the outlook for small business credit availability. We have emerged from the credit crunch into a much sounder financing environment and a well-balanced economic expansion. Bank balance sheets are vastly improved. Moreover, many of the new developments in banking point to more efficient risk management techniques that could lower costs of small business lending. At the same time, many of our large banks have become quite actively involved in small business and community development programs.

Our conversations with bankers and small business groups suggest that bank regulatory issues are not the pressing concern today that they were a few years earlier. Nonetheless, we as regulators will continue to review our rules and procedures to ensure that unnecessary burdens do not hinder banks' willingness to lend to creditworthy small businesses.